

Indiana Legislative Services Agency

Fiscal Issue Brief

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Business Income Subject to Indiana's Individual Income Tax

There is little information available on the amount and types of business income that flow through state individual income tax systems.¹ This lack of information results from the way that many state individual income tax systems are structured. Income generated by certain business organizations and activities is, in fact, taxed under federal and state individual income tax systems, not corporate income tax systems.² Various sources of business income are documented on the federal individual income tax return (Form 1040) and its various schedules as components of federal Adjusted Gross Income (FAGI). In 26 states, including Indiana, the starting point for computing the state individual income tax is FAGI.³ Thus, detailed information about the business income included in FAGI and flowing through Indiana's individual income tax system is not readily available on the Indiana individual income tax return. Rather, data from Indiana tax returns must be analyzed along with federal tax return data in order to determine the business income that is ultimately subject to Indiana's individual income tax.

This issue brief summarizes the results of a project to determine the magnitude and sources of business income that flow through the Indiana individual income tax system. It also analyzes how business income fluctuates with the business cycle and highlights the distribution of taxable income among returns with at least one form of business income in 1999 and 2001.

2001 Business Income and Losses in Indiana⁴

Net income and net losses (gross receipts less total expenses) from sole proprietorships, farms, partnerships and S corporations, Real Estate Mortgage Investment Conduits (REMICs), rental real estate, royalties, capital gains, and dividends are reported on the federal individual income tax return (Form 1040) as components of FAGI. In 2001, just over 1 million individual income tax returns filed by Indiana residents included at least one of these types of business income. This total represented about 33% of all individual income tax returns filed in Indiana in 2001. Table 1A shows the number of returns filed in 2001 including one of the above-described types of business income/loss, as well as other descriptive statistics for these business income/loss categories.

Dividends and capital gains, sole proprietorships, rent and royalties, and partnerships and S corporations generate the preponderance of business income or losses to individual filers. Returns with dividend income are most numerous, totaling 574,000, followed by returns with capital gains or losses, totaling over 504,000. Sole proprietorship income is present on over 312,000 returns. About 167,000 returns contain income or losses from rent and royalties. About 126,000 returns include income or losses from partnerships and S corporations.

¹ National aggregates are available. See for example Campbell, David and Parisi, Michael. "Individual Income Tax Returns, 2001," Statistics of Income Bulletin. Washington, D.C.: Internal Revenue Service, Fall 2003.

² Forms of business organization commonly taxed under individual rather than corporate income tax systems include sole proprietorships, partnerships, S corporations, and various other joint ventures except C corporations. Limited Liability Companies (LLCs) that elect to be treated as a partnership or sole proprietorship are taxed through individual income tax systems. LLCs that elect to be treated as a corporation are taxed through corporate income tax systems.

³ Federation of Tax Administrators, January 1, 2004. <http://www.taxadmin.org>.

⁴ All calculations used in this analysis are based on data available in LSA databases through December 2003.

Net income from sole proprietorships, partnerships and S corporations, and rent and royalties totaled about \$10 billion in 2001, or about 5.3 percent of Gross State Product.⁵ Over half, or about \$5.5 billion, was generated by partnerships and S corporations, with sole proprietorships generating approximately \$3.7 billion. Net income from capital gains and dividends totaled \$5.6 billion, or 2.9 percent of Gross State Product.

The average net income from these businesses is quite different, however. Partnerships and S corporations generated an average of about \$63,000 in net income per return, while sole proprietorships generated an average of only about \$15,500 per return. Capital gains generated \$11,000 per return. Well below the other categories, rent and royalties generated about \$840 million in net income, with an average of about \$8,000 per return. Dividends generated \$2,800 per return.

Table 1A: Net Business Income and Losses from 2001 Individual Income Tax Returns, By Type

	Sole Proprietorships ^a		Farm ^b	
	Net Income	Net Loss	Net Income	Net Loss
Number of Returns	239,795	72,492	22,482	33,028
Average (\$)	15,556	-4,715	14,176	-9,231
Std. Deviation ^e (\$)	39,048	22,729	24,633	17,391
Total (\$)	3,730,364,917	-341,788,553	318,704,700	-304,885,471
25 th Percentile (\$)	1,413	-5,106	1,105	-11,303
Median (\$)	4,933	-2,027	5,123	-5,252
75 th Percentile (\$)	14,838	-692	17,413	-2,069

	Rent & Royalty ^c		Partnerships & S Corporations ^c	
	Net Income	Net Loss	Net Income	Net Loss
Number of Returns	104,837	62,808	86,707	39,368
Average (\$)	8,015	-4,938	63,153	-18,781
Std. Deviation ^e (\$)	31,779	8,771	270,414	380,521
Total (\$)	840,319,847	-310,164,639	5,475,839,462	-739,382,194
25 th Percentile (\$)	963	-5,933	2,799	-12,257
Median (\$)	2,658	-2,730	13,722	-3,734
75 th Percentile (\$)	7,047	-1,078	46,451	-839

	REMICs ^{c,d}		Capital Gain or Loss		Dividends
	Net Income	Net Loss	Net Gain	Net Loss	Income
Number of Returns	404	35	359,444	144,809	574,008
Average (\$)	3,197	-1,960	11,047	-1,951	2,824
Std. Deviation ^e (\$)	36,307	4,584	217,973	1,660	39,011
Total (\$)	1,291,772	-68,605	3,970,848,006	-282,544,654	1,620,908,206
25 th Percentile (\$) ^f	2	-1,939	244	-3,000	49
Median (\$)	13	-195	969	-2,775	296
75 th Percentile (\$)	213	-13	4,079	-647	1,516

Source: LSA analysis of Indiana Department of State Revenue data.

^a From Federal Schedule C

^b From Federal Schedule F

^c From Federal Schedule E

^d REMICS are Residual Holders of Real Estate Mortgage Investment Conduits.

^e The standard deviation is the average difference between each observation and the mean.

^f Twenty-five percent of returns have a net income (net loss) below the 25th percentile, while 75 percent of returns have a net income (net loss) higher than this value. Fifty percent of returns are below the median, and 75 percent of returns are below the 75th percentile. Maximum and minimum values are not reported due to confidentiality concerns.

⁵ Gross State Product is the value added in production by the labor and property located in a state. It is often considered the state counterpart to the nation's gross domestic product.

For each type of business activity summarized in Table 1A, the frequency of returns reporting a net loss as well as the absolute magnitude of total net losses reported were substantially lower than for returns reporting net income. In comparison, net capital losses totaled around \$283 million, while net losses from sole proprietorships, partnerships and S corporations, and rent and royalties totaled about \$1.4 billion. Over half of that amount, or about \$739.4 million, was generated by partnerships and S corporations. Net losses from sole proprietorships totaled about \$341.8 million, roughly the same as losses resulting from rent and royalties, about \$310 million.

As would be expected, the proportion of returns containing net income and net losses from farming is fairly small, while REMICs generated comparatively little activity. Farm income was the only category in which the number of returns containing net losses exceeded the number containing net income (33,028 to 22,482). Net income and net losses reported from farming were almost equal at \$318.7 million and \$304.9 million, respectively.

Each business income/loss category also exhibits considerable variability as measured by the percentile values and the standard deviation. Variability is extremely pronounced for returns with net income/losses from partnerships and S corporations. The standard deviation indicates that net income varied around the average (equal to about \$63,000) by an average of about \$270,000. Thus, for a large portion of returns containing partnerships/S corporations, net income fell within a range from about \$1 to \$333,000. Given the average net loss generated by partnerships and S corporations of about \$19,000 and the standard deviation of about \$381,000, a large portion of returns with net losses from partnerships and S corporations fell within a range from about \$1 to about \$400,000. While not as pronounced, variability in net income and net losses generated by capital gains, dividends, sole proprietorships, rent, and royalties was also substantial.

Business Cycle Influences

Business income statistics from 1999 are compared to those for 2001 to examine the fluctuation of business income with the business cycle. Return counts and other descriptive statistics for 1999 are detailed in Table 1B. The year 1999 was in a period of economic expansion, while much of 2001 was in a recessionary period. Thus, the comparison highlights the economic contraction and accompanying decline in business activity and income occurring during this period. Over 938,000 individual income tax returns in 1999 reported net business income or losses compared to 1.0 million returns in 2001.

The comparison of data from 1999 and 2001 exhibits the expected pattern. Consequently, 1999 generally shows more returns containing net business income, lower totals of net business losses, and fewer returns containing net business losses. The exceptions were returns containing net losses from farming and income from REMICs. More returns showed a net loss from farming in 1999 than in 2001, about 34,800 in 1999 compared to about 33,000 in 2001. However, returns containing net income from REMICs showed substantial growth between 1999 and 2001, increasing from 294 to 404 returns.

Capital gains and dividend income were substantially higher in 1999 (compared to 2001), totaling \$6.1 billion and \$1.9 billion, respectively. Net income from sole proprietorships, partnerships and S corporations and rent and royalties totaled about \$10.2 billion in 1999. Similar to 2001, partnerships and S corporations and sole proprietorships, generated the preponderance of net business income in 1999 -- about \$5.7 billion and \$3.7 billion, respectively. As with 2001, rent and royalties generated significantly less net income than sole proprietorships and partnerships and S corporations, with a total of \$846 million.

As expected, the number of returns claiming net loss and the absolute amount of the loss was lower in 1999 than in 2001. Combined net losses for sole proprietorships, S corporations, and rents and royalties totaled \$1.1 billion in 1999, and partnerships and S corporations generated over half.

The dollar values in Table 1A and 1B are not strictly comparable because they are not adjusted for inflation (prices increased 6.3 percent between 1999 and 2001 as measured by the Consumer Price

Index for urban consumers). After adjusting for inflation, net REMIC income was higher in 2001 than in 1999, while net income from sole proprietorships, rent and royalties, S corporations and partnerships, farming, capital gains, and dividends was lower in 2001 than in 1999.

Table 1B: Net Business Income and Losses from 1999 Individual Income Tax Returns, by type

	Sole Proprietorships ^a		Farm ^b	
	Net Income	Net Loss	Net Income	Net Loss
Number of Returns	242,133	69,697	22,568	34,824
Average (\$)	15,258	-4,408	13,975	-8,859
Std. Deviation ^e (\$)	39,347	40,108	30,160	16,798
Total (\$)	3,694,464,435	-307,248,852	315,387,549	-308,488,470
25 th Percentile (\$)	1,336	-4,696	1,069	-10,741
Median (\$)	4,741	-1,878	5,032	-4,924
75 th Percentile (\$)	14,429	-629	17,015	-1,957

	Rent & Royalty ^c		Partnerships & S Corporations ^c	
	Net Income	Net Loss	Net Income	Net Loss
Number of Returns	110,610	60,111	88,201	37,311
Average (\$)	7,647	-4,257	64,504	-14,653
Std. Deviation ^e (\$)	27,641	7,652	319,606	178,816
Total (\$)	845,889,265	-255,905,003	5,689,342,916	-546,720,884
25 th Percentile (\$)	903	-5,042	2,468	-10,234
Median (\$)	2,478	-2,303	12,667	-3,038
75 th Percentile (\$)	6,599	-906	45,305	-650

	REMICs ^{c,d}		Capital Gain or Loss		Dividend
	Net Income	Net Loss	Net Gain	Net Loss	Income
Number of Returns	294	37	387,890	73,242	569,342
Average (\$)	1,464	-1,077	15,834	-1,712	3,319
Std. Deviation ^e (\$)	8,098	2,879	262,206	2,071	40,554
Total (\$)	430,325	-39,860	6,141,909,649	-125,386,174	1,889,413,739
25 th Percentile (\$) ^f	3	-392	388	-3,000	75
Median (\$)	16	-69	1,807	-1,722	434
75 th Percentile (\$)	89	-27	6,827	-365	2,015

Source: LSA analysis of Indiana Department of State Revenue data.

^a From Federal Schedule C

^b From Federal Schedule F

^c From Federal Schedule E

^d REMICS are Residual Holders of Real Estate Mortgage Investment Conduits.

^e The standard deviation is the average difference between each observation and the mean.

^f Twenty-five percent of returns have a net income (net loss) below the 25th percentile, while 75 percent of returns have a net income (net loss) higher than this value. Fifty percent of returns are below the median, and 75 percent of returns are below the 75th percentile. Maximum and minimum values are not reported due to confidentiality concerns.

Share of Individual Income Tax Revenue Attributable to Business

To estimate the share of individual income tax revenue attributable to business, we calculated Indiana taxable business income as a share of Indiana taxable income for each business category. Indiana taxable income was approximately \$105.8 billion for 2001 and \$104.4 billion for 1999 (not adjusted for inflation). Net income from Tables 1A and 1B for each business category is taxable business income. Table 2 shows the share of taxable income attributable to each business category. Taxable Income from partnerships and S corporations are the largest portion of Indiana taxable income at 5.2 percent for 2001, while taxable income from capital gains was the largest share at 5.9% in 1999.

Individual Adjusted Gross Income Tax revenue was approximately \$3.58 billion in 2001 and \$3.54 billion in 1999 (not adjusted for inflation), so the share of tax revenue paid by business was approximately \$540 million and \$630 million in 2001 and 1999, respectively. This represents less than one percent of gross state product and about 6 percent of state operating revenue for FY 2001 and 7 percent in FY 1999.

Table 2: Share of Taxable Income Attributable to Business

	2001 Share	1999 Share
Sole Proprietorships	3.5%	3.5%
Rent and Royalty	0.8%	0.8%
Partnership and S Corporation	5.2%	5.4%
REMICs	0.0%	0.0%
Dividend Income	1.5%	1.8%
Capital Gains	3.8%	5.9%
Total Nonfarm	14.8%	17.5%
Farm	0.3%	0.3%

Source: LSA analysis of Indiana Department of State Revenue data.

Income Distribution of Tax Filers Reporting Business Income

Table 3 shows the distribution of Indiana taxable income for returns that include at least one form of business income for 2001 and 1999. Taxable Income includes not only business income from the sources described above but also wage and salary income, interest income, Social Security, etc. Indiana taxable income is equal to FAGI plus add backs of federal deductions not allowed by Indiana, minus Indiana deductions and exemptions. The taxpayer's gross tax liability is computed on taxable income, and then tax credits are applied.

The distribution is positively skewed, with the preponderance of returns falling at or below \$50,000 in taxable income. The amount of taxable income on the average tax return is \$58,000 and \$61,000 respectively for 2001 and 1999. Of the 1.0 million returns with business income filed in 2001, 61.1 percent had taxable income of \$50,000 or less, 88.7 percent had taxable income of \$100,000 or less, and 98.0 percent had taxable income of \$250,000 or less. A similar pattern holds for 1999 although there are more returns at the lower and upper ends of the distribution. Again, the 1999 and 2001 results are not strictly comparable since the income ranges are not adjusted for inflation between the two years, but general comparisons can be made.

Table 3: Distribution of Indiana Taxable Income on Indiana Individual Income Tax Returns with Business Income

	2001 Number of Returns	2001 Percent of Returns	2001 Cumulative Percent of Returns	1999 Number of Returns	1999 Percent of Returns	1999 Cumulative Percent of Returns
NONE (No Taxable Income)	14,955	1.5	1.5	13,370	1.4	1.4
\$1 - \$5,000	67,032	6.7	8.2	69,449	7.4	8.8
\$5,000 - \$10,000	68,192	6.8	15.0	69,383	7.4	16.2
\$10,000 - \$25,000	194,842	19.4	34.4	176,735	18.8	35.0
\$25,000 - \$50,000	267,329	26.7	61.1	245,870	26.2	61.2
\$50,000 - \$100,000	277,158	27.6	88.7	254,945	27.2	88.4
\$100,000 - \$250,000	93,224	9.3	98.0	87,361	9.3	97.7
\$250,000 - \$500,000	13,813	1.4	99.4	14,374	1.5	99.2
\$500,000 - \$1,000,000	4,388	.4	99.8	4,913	.5	99.8
Over \$1,000,000	1,844	.2	100.0	2,299	.2	100.0
Total	1,002,777	100.0		938,699	100.0	

Source: LSA analysis of Indiana Department of State Revenue data.

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